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Capital Controls and the Current Financial Crisis:
Revisiting the Malaysian Experience

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The severity of the ongoing financial crisis has heightened concerns about the negative impact of unregulated capital movements on developing countries. This concern has also revived the debate on the effectiveness of temporary capital controls as a policy response to such a crisis.

The debate on capital controls, which was started about a decade ago, at the time of the Asian financial crisis, remains unresolved. On one side, some economists argue that temporary capital controls are an effective way to stabilize an economy facing a severe external financial crisis, especially when 'standard' macroeconomic responses have failed. On the other side, some economists argue that capital controls are used primarily as a vehicle for supporting politically-connected businesses.

Drawing on the Malaysian experience with temporary capital controls in 1998-99, this Development Viewpoint argues that temporary capital controls can be, under certain circumstances, an effective way for developing countries to insulate themselves from the contagion effects of a financial crisis.

We also point out that such controls could be used by developing countries to 'maintain domestic ownership of local firms' (Cooper, 1999) if that were a policy objective. However, we note that the success of temporary controls hinges on the extent to which a country's central bank can supervise and regulate the financial sector. In the absence of such a condition, Malaysian-style capital controls could not be easily replicated.

We therefore suggest the need for further studies of other forms of controls, such as a two-tiered currency transaction tax (see Nissanke 2005). Such a tax would include a zero or very low tax rate on currency transactions during tranquil market conditions but a higher temporary surcharge automatically imposed during speculative attacks on a country's currency. Being able to impose such a surcharge would help central banks defend their currencies without having to resort to building up large international reserves or tightly regulating the financial sector.

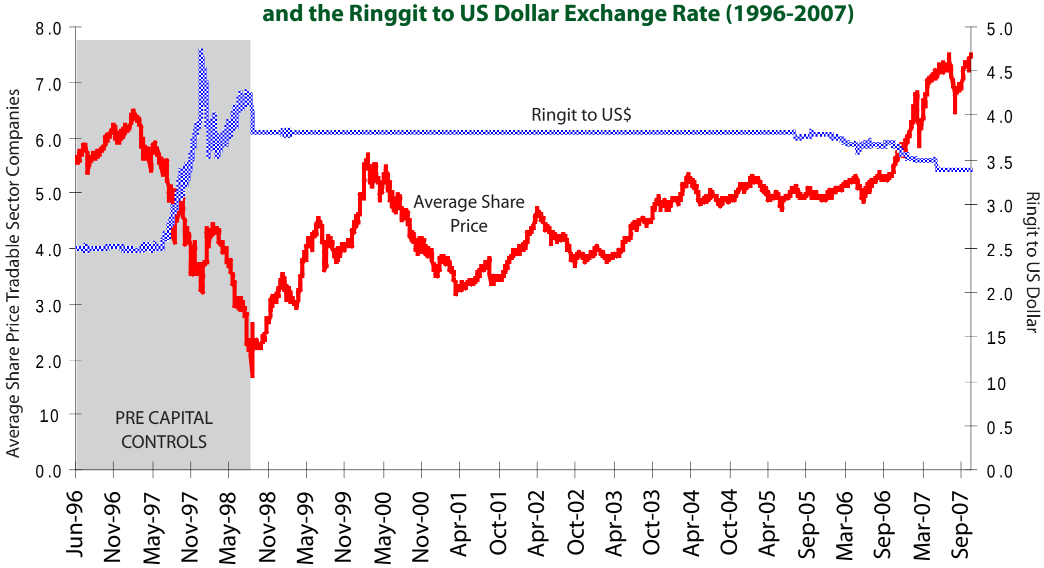
Free Capital Mobility
Mainstream macroeconomic literature assumes that the effects of financial globalisation on economic development are positive. One of the key assumptions is that when impediments to free capital mobility are removed, funds should flow from capital-rich to capital-poor countries. Such capital flows are also assumed to improve the quality of governance of financial institutions and corporations, as well as strengthen the influence of market discipline on economic policy making.

However, in the aftermath of the Asian financial crisis of 1997-98, financial globalisation started to be challenged. Since then, a number of prominent studies have shown that there is little empirical evidence to the claim that international private capital flows are conducive to economic growth. Instead, the evidence indicates that they tend to increase financial fragility and the likelihood of financial crisis.

In addition, because private capital flows tend to be procyclical, they do not provide developing countries with a useful disciplining function. There is also growing evidence that capital does not flow from rich to poor countries. In contrast, in the 2000s capital has flowed in the opposite direction, creating significant macroeconomic imbalances (see Cozzi and Nissanke 2009). Nonetheless, strong opposition still exists to any form of controls on private capital flows.

Our review of the Malaysian experience with capital controls suggests that it is important to focus the debate on which controls could be most effective and under what circumstances, rather than opposing them as a matter of economic principle.

The Average Share Price (in Ringgit) of the Tradable Sector and the Ringgit to US Dollar Exchange Rate (1996-2007)



Source: Thompson Reuters Datastream

The Malaysian Experience
We have assessed, in particular, the temporary capital controls imposed in Malaysia in 1998-99 by trying to measure their impact on private agents. The objective of our research has been to identify the responses of different industrial sectors as well as politically-connected and politically-independent businesses, both to the imposition of controls and their removal (see Cozzi and Nissanke 2009).

Our study found that the initial response to capital controls of the tradable sector in Malaysia was negative, since it exhibited statistically significant negative abnormal returns on share values on the day that capital controls were imposed (and the Malaysian Ringgit was pegged to the US Dollar).

The Figure shows the trend in both the average share price of Malaysian tradable companies included in the Kuala Lumpur Composite Index (a capitalization-weighted stock market index of the top 100 companies) and the Ringgit to US Dollar Exchange Rate. It reveals that after capital controls were imposed and the exchange rate was fixed in 1998, the average share price of tradable companies—despite dropping initially—recovered significantly through 2000.

The results of our study suggest that capital controls, combined with the exchange rate peg, created stability in the currency and stock markets, and acted as a stimulus to the tradable sector. Thereafter, this sector, and particularly its electronics and resource-based industries, played a pivotal role in the recovery of the Malaysian economy.

Our study also indicates that the imposition of capital controls impacted differentially on politically-connected and politically-independent businesses. Politically-independent businesses exhibited an immediate negative response, as their share values markedly declined, while the share values of politically-connected firms did not change significantly.

Our findings suggest, however, that the imposition of capital controls in Malaysia did not serve to *exclusively* support politically-connected businesses. By creating stability in the currency and stock markets, the controls ultimately favoured the tradable sectors of the economy as a whole.

Interviews conducted with Malaysian government officials also suggest that the imposition of capital controls enabled them to continue implementing affirmative pro-Malay policies without external interference and maintain the domestic ownership of Malaysian firms. We argue that such conditions were important because they were essential to guaranteeing political and social stability. Ultimately, this stability benefited both politically-connected and politically-independent businesses.

A year after the imposition of capital controls, that is, on 4th February 1999, they were loosened substantially. Our study found that none of the businesses that we examined exhibited marked changes in share values on the day of the removal of controls. This effect implies that loosening capital controls did not significantly affect the asset values and behaviour of Malaysian firms.

Impact and Lessons

Thus, we contend that capital controls assisted the recovery of the Malaysian economy and helped bring back stability to the currency and stock markets. If the imposition of capital controls had been perceived negatively by investors during 1998, we would have expected that the *loosening* of capital controls in 1999 would have led to the formation of positive abnormal returns.

Capital controls in Malaysia were successful because, in part, there was little attempt to evade them. This was due to the characteristics and structure of the Malaysian banking system. For instance, the central bank of Malaysia had strong supervisory and regulatory powers. Also, domestic commercial banks had the largest share of the financial market in the 1990s. Furthermore, the government controlled, either directly or indirectly, four of the largest banks.

Our findings confirm that capital controls can be, under certain conditions, an effective mechanism to insulate developing countries from the contagion effects of a financial crisis and can help reduce financial fragility. They can also be a useful tool to protect the domestic ownership of local firms.

However, our study also suggests that the success of capital controls in Malaysia depended on the degree to which the central bank had significant supervisory powers and the domestic financial sector was effectively regulated. The measures used for capital control were comprehensive but cumbersome, embracing wide-ranging restrictions on various transactions.

Hence, replicating Malaysian-style capital controls elsewhere would be difficult in the absence of a strong oversight and enforcement system. We suggest therefore that the potential of other mechanisms for controlling destabilising cross-border capital flows, such as a system of a two-tiered currency transaction tax, should be considered seriously as part of a new post-crisis global financial architecture.

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